DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

June 27, 2002

Number: **200242006**
Release Date: 10/18/2002
CC:PSI:2/POSTF-150620-01
UILC: 9926.00-00, 162.30-00, 351.00-00, 6662.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ANDREW J. MANDELL
CC:LM:FS:LI

FROM: Matthew Lay
Senior Technician Reviewer CC:PSI:2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 4, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =
Business =

Promoter =
Partnership =
Bank =
Appraiser =
Subsidiary =
Country =
Equipment 1 =
Equipment 2 =
Equipment 3 =
Year 1 =
Year 2 =
Date 1 =
Date 2 =
Date 3 =

Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
$a	=
$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
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$j	=
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ISSUES

1. Whether a series of prearranged transactions entered into by Taxpayer lacked economic substance and had no business purpose.

2. Whether the purported sale of the right to receive rental income was a financing and not a sale.

3. Whether the transfer of property to Subsidiary qualifies under §351.

4. If the transaction is held to have economic substance and the transfer from the Partnership to the Subsidiary of Taxpayer qualify under §351, whether the payments by Taxpayer to Bank are capital expenditures.

5. Whether the accuracy related penalty provided by §6662 applies to deficiencies that result from disallowing the rental deductions claimed by Taxpayer.

CONCLUSIONS

1. The series of prearranged transactions entered into by Taxpayer lacked economic substance and had no business purpose.

2. The purported sale of the right to receive rental income was a financing and not a sale.

3. The transfer of property to Subsidiary does not qualify under §351.

4. The payments by Taxpayer to Bank are not capital expenditures.

5. The accuracy related penalty provided by §6662 applies to deficiencies that result from disallowing the rental deductions claimed by Taxpayer.

FACTS

Taxpayer, a publicly held corporation, is engaged in Business. Taxpayer is the common parent of an affiliated group of corporations that file a consolidated federal income tax return. On Date 1, Promoter presented for Taxpayer's consideration a transaction, referred to as Promoter's "Asset Finance Strategy," designed to achieve lower cost financing for the purchase of equipment. Promoter described this strategy as an "alternative form of financing [that] is comparable in pre-tax efficiency to other, more traditional forms of financing." However, "[o]n an after-tax basis it reduces the cost of using the asset by as much as 30%." Shortly after this meeting, Taxpayer began to isolate assets that would work in the context of the proposed transaction. The Bank indicated its willingness to provide the necessary financing.

The benefits derived by Taxpayer from entering into the transactions were highlighted in a memo dated Date 2 (the "Bank Memo"). The Bank Memo described a 4-step equipment finance structure. The structure involved Taxpayer, a subsidiary of Taxpayer, and a foreign partnership with foreign owners. The Bank Memo described the following 4 transactions:

Transaction 1: The partnership purchases equipment (Equipment 1, Equipment 2, and Equipment 3) at fair market value. The partnership finances the purchase with an equity note (approximately 20%) and a finance note (approximately 80%).

Transaction 2: The partnership leases the equipment to Taxpayer for a months (Equipment 1) and b months (Equipment 2 and Equipment 3).

Transaction 3: The partnership sells the lease payment stream (the "Rent Sale") to Bank and uses the proceeds from the Rent Sale to pay the finance note.

Transaction 4: If the partnership and Taxpayer's subsidiary agree to terms, the partnership will transfer to the subsidiary, in a tax-free exchange, the following: (1) ownership of the equipment, and (2) the remaining 20% equity note obligation.

The transactions that actually occurred are described below.

1. Sale-Leaseback Transactions

On Date 3, Taxpayer entered into an agreement (the "Purchase Agreement") through which it sold certain Equipment 1, Equipment 2, and Equipment 3 (the "Equipment") to Partnership, a Country limited partnership. The Partnership's 99% owner and general partner is a foreign individual and the 1% partner is a foreign entity.

The purchase price paid by Partnership for the Equipment was determined by reference to a Appraiser report in which the aggregate fair market value of the equipment was appraised at $a. The appraisal was not performed via an inspection of the equipment, but rather it relied upon a "desktop investigation" in which Taxpayer provided asset descriptions. The appraisal was undertaken at the request of Partnership, but was commissioned and paid for by Promoter.

Partnership financed its purchase of the Equipment through the execution and delivery of a secured nonrecourse note (the "Finance Note") in the amount of $b and a secured recourse promissory note (the "Equity Note") in the amount of $c.

Under the terms of the Finance Note, Partnership promised to pay Taxpayer the principal sum of $b, together with interest on the unpaid balance thereof from Date 3. Subject to certain prepayment and acceleration clauses the Finance Note was payable in c total installments compromised of: (1) d equal quarterly installments of $d, (2) followed by e equal quarterly installments of $e, and (3) finally by f equal quarterly installments of $f. Under the Equity Note, Partnership promised to pay Taxpayer the full principal amount of $c without interest on Date 4.

Under the Purchase Agreement, the Equipment was represented to have been "in good working order and repair." It has been determined, however, that one of the machines was abandoned and written off in Date 5 without ever having been placed in Service. Moreover, two of the machines were not completed until Date 6 and Date 7, respectively.

The Equipment was immediately leased back to Taxpayer by Partnership pursuant to a separate lease agreement (the "Equipment Lease"). Under the Equipment Lease, Taxpayer leased the computers for a a month period and the Equipment 2 and Equipment 3 for a b month period. Taxpayer agreed to make the following rental payments to Partnership with respect to the equipment: (1) for the Equipment 1, g consecutive quarterly installments of $g, (2) for the Equipment 2, d consecutive quarterly installments of $h followed by h consecutive quarterly installments of $i, and (3) for the Equipment 3, i consecutive quarterly installments of $j followed by i consecutive quarterly installments of $j.

To secure Partnership's payment of principal and interest when due, the Finance Note granted Taxpayer a purchase money security interest in (i) the Equipment, (ii) the Equipment Lease, (iii) all rental payments due Partnership under the Equipment Lease, and (iv) all proceeds of any of the foregoing (the "Collateral"). The security interest created by the Finance Note was, in all respects, senior to the security interest created by the Equity Note.

The Equity Note was secured with a purchase money security interest in Partnership's right, title, and interest in the Collateral. However, Taxpayer's lien on the Equipment Lease (but not its lien on the Equipment) and any proceeds thereof was to automatically terminate upon the payment in full of the Finance Note.

Under the Equipment Lease, Taxpayer was responsible for all costs and expenses of any nature whatsoever for the possession and operation of the Equipment, including any related taxes, fines, duties, and penalties (the "General Tax Indemnity"). In addition, during the term of the lease Taxpayer assumed all risk of loss, damage, theft and condemnation with respect to the Equipment. In the event that Taxpayer failed to make a rental payment, Partnership was afforded a number of remedies under the Equipment Lease. The remedies included the right to declare all accrued but unpaid rents immediately due and payable as well as the right to repossess and sell or re-lease the Equipment to recover the unpaid rent. The Equipment Lease also provided Partnership with the right to assign, sell, transfer, or grant a security interest in all the Equipment to a "Qualified Assignee" upon written notice to Taxpayer. A "Qualified Assignee was defined as any financial institution with net worth in excess of $k that was not affiliated with any of Taxpayer's competitors listed in the Equipment Lease. Upon written notice, Partnership also had the right to sell all or any portion of the rental payments due from Taxpayer to a Qualified Assignee.

Upon expiration of the initial lease term, Taxpayer had an option to purchase the equipment at its fair market value. A Appraiser appraisal provided to Partnership stated that the residual value of the Equipment at the end of the lease term would be approximately 15% to 25% of $a, the estimated fair market value of the Equipment on the appraisal date.

2. Rent Sale

On Date 8, one day after Date 1, Partnership sold the rights to receive a specified number of quarterly payments under the Equipment Lease, valued at $l, to Bank for $m in cash pursuant to a rent sale agreement (the "Rent Sale Agreement"). The purchase price of the rent payments acquired by Bank was determined by discounting the amount of each rent payment on a quarterly basis from its scheduled payment date back to Date 2.

Under the Rent Sale Agreement, Bank acquired the right to receive the following rental payments required to be paid by Taxpayer under the Equipment Lease: (1) the first i payments scheduled with respect to the Equipment 1, (2) the first c payments scheduled with respect to the Equipment 2, and (3) the first c payment scheduled with respect to the Equipment 3. Bank also acquired the right to any payment made under the Equipment Lease for lost, damaged, or destroyed equipment items, the right to the General Tax Indemnity provided under the Equipment Lease, and the right to declare all accrued and unpaid rents immediately due and payable. Bank did not acquire any interest in the Equipment, nor did it acquire any right to possess the Equipment. Bank accounted for the rent sale transaction as a loan to Taxpayer for both tax and financial reporting purposes.

Approximately $n of the rent sale proceeds due Partnership, per Partnership's direction, was wired directly by Bank to Taxpayer's bank account. Of the total amount wired to Taxpayer approximately $o was paid in satisfaction of the Finance Note, and approximately $p represented one-day's interest on the principal amount of the Finance Note. Taxpayer reported the payment of the Finance Note funded by Bank as a financing on its financial reports.

3. Transfer to Subsidiary

Taxpayer's Year 1 taxable year ended on Date 9. On Date 10, Subsidiary, a wholly owned subsidiary of Taxpayer, entered into an agreement with Partnership. Partnership agreed to acquire j shares of Subsidiary Series A preferred stock in exchange for Partnership's interest in the Equipment and the Equipment Lease. The interest transferred by Partnership to Subsidiary included Partnership's right to the rent payments due under the Equipment Lease that were not sold to Bank under the Rent Sale agreement (the "Retained Rents"). According to Subsidiary's Board of Directors, the fair market value of this interest at the time of the exchange was $q.[1]

The exchange was effected through the execution of a separate agreement, dated Date 10. Under the terms of this agreement, Subsidiary accepted the assignment of Partnership's interest in the Equipment and the Equipment Lease, and agreed to assume all of Partnership's obligations to Taxpayer arising from the sale-leaseback transaction. Included in these obligations was Partnership's obligation to pay Taxpayer $c due on the Equity Note, as of Date 4.

Partnership's obligation to acquire Subsidiary preferred shares was conditioned upon the simultaneous contribution by Taxpayer to Subsidiary of $r in exchange for common stock. These two transactions were intended to qualify as tax free exchanges under §351. Taxpayer recorded, in its general journal, its additional cash investments in Subsidiary in Date 11. On Date 12, Subsidiary made a $r payment to Taxpayer in satisfaction of Equity Note, with the balance of the payment being accounted for as a dividend.

In connection with the exchange between Partnership and Subsidiary, Appraiser issued separate appraisal reports to each party. Both reports were dated Date 13. The report issued to Partnership reaffirmed the residual value of the Equipment at the end of the Equipment Lease that was presented in the original appraisal report, i.e., 15% to 25% of $a (i.e. approximately $s to $t). The report issued to Subsidiary, however, listed the residual value of the Equipment on Date 13 as $u, or at least $v higher than the value reported to Partnership.

4. Taxpayer's Returns

The sale of the Equipment to Partnership under the Purchase Agreement was not reported by Taxpayer on its Year 1 tax return. For Year 1, no depreciation deduction was claimed by Taxpayer with respect to the Equipment.

[1] It is unclear how the Board of Directors calculated the $q value for the equipment when, as indicated below, the residual value of the Equipment was appraised at $u in the Appraiser report issued to Subsidiary.

Taxpayer also failed to report the §351 transaction on its Year 2 tax return. Beginning in Year 2, Taxpayer resumed its depreciation of the Equipment on its portion of the consolidated return. In addition, Taxpayer began deducting the full amount of all payments to Bank. These deductions were not reflected as rental payments to Bank. Rather, Taxpayer deducted a portion of the payments as an interest expense, and the remaining amounts as additional depreciation. The amounts characterized as depreciation corresponded to the reduction in the principal amount owed to Bank.

The total fees incurred by Taxpayer in connection with the transaction amounted to $w. Beginning with the Year 2 fiscal year, this amount is being amortized over a 6 year period for book and tax purposes. In addition, Subsidiary began to amortize $x over a twelve year period beginning in Year 2. This amount represents "other assets" recorded by Subsidiary upon the issuance of its preferred shares.

LAW AND ANALYSIS

Issue 1: Economic Substance

A transaction that is entered into solely for the purpose of tax reduction and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. *Estate of Franklin v. Commissioner*, 64 T.C. 752(1975); *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 92 (4th Cir. 1985); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Nicole Rose Corp. v. Commissioner*, 117 T.C. 27 (2001). When a transaction is treated as a sham, the form of the transaction is disregarded and the proper tax treatment of the parties to the transaction is determined.

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. *United States v. Wexler*, 31 F.3d 117, 122, 124 (3d Cir. 1994); *Yosha v. Commissioner*, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g *Glass v. Commissioner*, 87 T.C. 1087 (1986); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); *Weller v. Commissioner*, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. *Cherin v. Commissioner*, 89 T.C. 986, 993-94 (1987); *ACM Partnership, supra*. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs. *Yosha v. Commissioner*, 87 T.C. 1087 (1986); *ACM Partnership, supra*.

Courts have consistently found that the potential for profit or loss on the sale or re-lease of the property is a crucial burden and benefit of owning property. *Gefen v. Commissioner*, 87 T.C. 1471, 1492 (1986). Crucial to the characterization of this transaction is which party bears the risk of economic loss or physical damage to the Equipment. The terms of the leaseback placed this burden on Taxpayer. Further, Partnership had little risk of loss, since it was planned that Partnership would sell the Equipment to Subsidiary in Transaction 4.

In *Frank Lyon Co. v. Unites States*, 435 U.S. 561 (1978), the Supreme Court overturned the Commissioner's determination that a sale-leaseback should be disregarded for tax purposes. The case involved the construction of a new bank building. Because banking regulations adversely affected the bank's ownership of the building, it found an investor to take title to the property and lease it to the bank for 25 years. At trial, the government acknowledged the existence of the fact and conceded that more than mere tax avoidance was behind the form of the transaction. The Court held that:

> [W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

435 U.S. at 583-84.

The present case is easily distinguishable from *Frank Lyon*. In *Frank Lyon*, the rationale for the transaction was the clear, non-tax reason for the bank to find an independent investor to take title to the property. Here, there is arguably no non-tax reason for the way the transactions were structured.

We believe that the transactions described above were, in substance, a simple financing transaction in which Taxpayer transferred the Equipment to a Subsidiary while borrowing about $y (directly or indirectly) from Bank. Moreover, the issuance of preferred stock to Partnership in the purported §351 exchange was, in substance, a fee for Partnership's services in facilitating the tax motivated transactions by reporting income from the rent sale. We further believe that there was no objective economic substance or business purpose for structuring the transactions described above as a sale-leaseback followed by a purported §351 exchange rather than as a simple financing. Rather, the sole purpose of structuring the transactions as a sale followed by a purported §351 exchange was the creation of tax benefits.

Neither Taxpayer nor Subsidiary could have expected to earn a pre-tax profit from the series of transactions. Based on the information provided, the Finance Note and the rental payments from Taxpayer to Partnership are nearly offsetting obligations. The Equity Note was, in essence, forgiven by Taxpayer when the obligation was assumed by Subsidiary, Taxpayer's wholly owned subsidiary, following the §351 transaction. Taxpayer also incurred $w in transaction costs by engaging in the lease strip which would further preclude a pre-tax profit. Further indication that Taxpayer had no true economic concerns regarding the transaction is that both Taxpayer and Subsidiary relied on an appraisal arranged by Promoter. A transaction involving equipment of such high value would ordinarily warrant an independent appraisal.

The transactions' closeness in time and prearrangement supports the argument that the outcomes of the transactions were known by the parties and that tax reduction was their primary goal. The transactions were each planned and scheduled to occur within a short period of each other. The Bank Memo, clearly indicates the prearranged nature of the transactions. The sale-leaseback, rent sale, and the purported §351 transaction all occurred within a 2 month period: Date 3; Date 8; and Date 10, respectively. The parties carefully planned these transactions and therefore knew of both the lack of pre-tax economic potential, discussed above, and of the tax reducing benefits of the transaction. The prearrangement and rapidity of the transactions nearly ensured that the results would be as foreseen and no additional possibility for either profits or losses would arise. Given the certainty of consequences, it becomes clear that the primary goal was the tax reduction.

The transaction lacks economic substance, and the deductions should be adjusted to reflect the real economics of the transaction. Taxpayer did receive funds from Bank, through Partnership, and the payments to Bank reflect a repayment of these funds. A portion of Taxpayer's payments should be allocated to a repayment of principal and another portion as payment of interest. Taxpayer should be allowed the deduction of interest paid to Partnership. Taxpayer never relinquished its ownership of the property for tax purposes, and therefore should be allowed MACRS depreciation on the equipment. The disallowed deduction is the second “depreciation” deduction taken by Taxpayer and represented by the “principal” portion of Taxpayer’s payments to Bank.

Issue 2: Sale v. Financing

In addition to the authorities described in the previous section, which support characterizing the transaction engaged in by Taxpayer, Partnership, and Subsidiary as a financing, there are additional cases specifically addressing the factors that are relevant in identifying the true owner of property that is involved in a sale-leaseback transaction. As discussed more fully below, we believe that these cases also support treating the transactions engaged in by Taxpayer, Partnership, and Subsidiary as a financing.

There are two ways to characterize the transactions as a financing and not as a bona fide sale. The first way is that the transactions were a financing by Partnership in which Partnership lent Taxpayer funds that it obtained from Bank. The second way is that the transactions were a financing by Bank in which Partnership acted as a conduit. With either characterization of the transactions, we would conclude, as discussed below, that the transactions were a financing, which was carried out as a series of four transactions. The real economic effect of the transactions was that Taxpayer transferred the Equipment to a subsidiary while borrowing approximately $y (directly or indirectly depending on how the transactions are viewed) from Bank. The issuance of preferred stock to Partnership in the purported §351 exchange was in substance a fee for Partnership’s services in facilitating the tax motivated transactions by reporting income from the rent sale.

The determination of who is the owner of property and, therefore, who is entitled to the tax benefits, focuses on the economic substance of a transaction, not its form. Here, whether the transaction was a financing and not a sale would depend on whether Partnership became the bona fide owner of the Equipment.

Whether a transaction is a sale, a lease, or a financing arrangement is a question of fact, which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. *Haggard v. Commissioner*, 24 T.C. 1124, 1129 (1955). Whether a transaction is a true sale and an operating lease as opposed to a financing arrangement will result in different tax consequences for both the seller-lessee and the buyer-lessor. The test for determining if a transaction is a sale, as opposed to a lease or a financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser. *Larsen v. Commissioner*, 89 T.C. 1229, 1267 (1987). The Tax Court has used the following factors to determine if the benefits and burdens of ownership pass in a transaction: (1) whether legal title passed; (2) whether the parties treated the transaction as a sale; (3) whether the purchaser acquired an equity interest in the property; (4) whether the sale contract obligated the seller to execute and deliver a deed and obligated the purchaser to make payments; (5) whether the purchaser is vested with the right of possession; (6) whether the purchaser pays property taxes after the transaction; (7) whether the purchaser bears the risk of economic loss or physical damage to the property; and (8) whether the purchaser receives the profit from the property's operation, retention and sale. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-38 (1981).

In determining the validity of a sale-leaseback transaction, the Tax Court also looks to (1) the existence of useful life of the property in excess of the leaseback term; (2) the existence of a purchase option at less than fair market value; (3) if renewal rentals at the end of the leaseback term are set at a fair market value rate; and (4) the reasonable possibility that the purported owner of the property can recoup its investment in the property from the income producing potential and residual value of the property. *Torres v. Commissioner*, 88 T.C. 702, 720-21 (1987); *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985).

Accordingly, all the facts and circumstances must be examined to determine the nature of a transaction. The facts and circumstances also will determine the relative importance given to each particular factor. For example, the court in *Torres* noted that a sale-leaseback involving a net lease has characteristics that may reduce the significance of certain factors in determining its true substance:

> [B]ecause net leases are common in commercial settings, it is less relevant that petitioner was not responsible for the payment of property taxes or that petitioner bears less of a risk of loss or damage to the property because the lessee is required to maintain insurance on the property. Similarly, a lessor is normally not vested with the right of possession during the term of the lease and, therefore, the relevant consideration in this regard is whether the useful life of the property extends beyond the term of the lease so as to give the purchaser a meaningful possessor right to the property. Also, in a leaseback transaction it is normal for the lessee to receive profits from the operation of the property while the lessor's receipt of payments is less dependent upon the operation of the property.

88 T.C. at 721.

The purported leaseback at issue in this case appears to be a net lease.

This question, therefore, is highly factual in nature. We believe that there is a basis to conclude that the transactions were a financing. In applying the factors discussed above to this case, we have a number of comments. The following discussion keys into the factors enumerated in *Grodt & McKay Realty, Inc.* and *Torres*.

1. Has legal title passed?

Regardless of whether title passed in the purported sale of the Equipment to Partnership, the final result of the series of steps was that Subsidiary, a subsidiary of Taxpayer, became the owner of the Equipment. This was planned as Transaction Four of the Bank Memo. Thus, this factor supports the view that there was no sale.

2. Did the parties treat the transaction as a sale?

The parties in some ways used the form of a sale, but a substance over form analysis shows that viewing the transactions as a whole the parties did not treat it like a sale. It is the substance of a transaction and not its legal form which is controlling for federal income tax purposes. *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939). The facts presented suggest an economic substance of the transaction different than the form, namely a financing arrangement.

Promoter, which proposed the transactions, seems to have described the transactions as a financing. The proposal was the "Asset Finance Strategy." Promoter described this Strategy as an "...alternative form of financing [that] is comparable in pre-tax efficiency to other, more traditional forms of financing." However, "[o]n an after-tax basis it reduces the cost of using the asset by as much as 30%." This indicates the parties intended to carry out a financing but to give it the form of a sale-leaseback for tax planning purposes. Although a taxpayer can use tax planning in structuring a transaction, there need to be non-tax considerations in structuring a transaction for the form to be respected.

Although Taxpayer allegedly sold the Equipment to Partnership, it was planned in advance that Partnership would sell the property to Subsidiary in Transaction Four. Further, Taxpayer reported the distribution from Bank as a financing on its financial reporting. The sale of the Equipment was not reported by Taxpayer on its Year 1 income tax return.

Taxpayer failed to report the purported §351 transaction on its tax return. This would be another indication that Taxpayer was not treating the purported sale of the Equipment to Partnership as a genuine sale. If Taxpayer had not in substance sold the property to Partnership, Taxpayer would not have treated it as having been acquired from Partnership by its subsidiary.

The fact that Taxpayer did not take depreciation for the Year 1 taxable year would favor treating the transaction as a sale. However, Taxpayer did resume depreciation of the Equipment in Year 2. When Taxpayer began deducting the payments to Bank, these payments were not reflected as rental payments, but were instead claimed as interest and depreciation expense on Taxpayer's tax returns.

The fact that the depreciation deductions were equal to the yearly reduction in the principal amount owed to Bank indicates that Taxpayer was treating non-deductible principal payments as deductible depreciation payments.

The fact that the depreciation deductions for the Equipment were claimed on Taxpayer's portion of the consolidated tax return indicates that Taxpayer acted as if it was still the owner of the property.

Further, Partnership instructed Bank to wire the sale price of the loan payments directly to Taxpayer. This is another reason to view Partnership as an intermediary in a financing.

The fact that, when Appraiser appraised the Equipment, it did not inspect the Equipment but instead performed a "desktop investigation" in which it relied on asset descriptions that were provided by Taxpayer may indicate that it was not a bona fide sale. Further, while the appraisal by Appraiser was ostensibly undertaken at the request of Partnership, it has been determined that the appraisal was commissioned and paid for by Promoter. If Partnership really was buying the Equipment, it may have acted differently.

As a whole, it looks like the parties never treated the transaction as a sale. Thus, this factor supports the view that there was no sale.

3. Did Partnership acquire an equity interest in the property?

Whether the buyer has acquired an equity interest in the property is often considered significant evidence of a sale. See *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976).

At the time of the sale of the Equipment to Partnership, Partnership paid the entire purchase price by issuing two notes. Thus, at the time of the sale, Partnership had no equity in the property. This raises the issue of whether Partnership stood to profit from appreciation in the value of the property. The terms of the sale provided Taxpayer an option to buy the property back from Partnership for fair market value at the end of the lease term. However, it was contemplated in the Bank Memo that, in Transaction Four, Partnership would sell the property to Subsidiary. Thus, Partnership was not expected to acquire any genuine equity in the Equipment. Partnership did acquire the preferred stock in Subsidiary after the series of transactions, but the preferred stock is best viewed as a fee for Partnership's role in the transactions. Since Partnership acquired preferred stock and not common stock, there was a limit to how much Partnership could gain from its ownership of the Equipment.

Thus, this factor also supports the view that there was no sale.

4. Did the sale contract obligate the seller to execute and deliver a deed and the buyer to make payments?

The facts do not indicate whether a deed was issued. If no deed was issued (assuming that deeds are normally issued when similar equipment is sold), that would be further reason to believe that no bona fide sale took place.

The Purchase Agreement did provide for Partnership to make payments on the two notes. Nevertheless, Partnership was not in fact expected to make any payments, since it was planned that Partnership would sell a portion of the rental payments to Bank and use the proceeds to pay off one of the notes, and it was planned that Partnership would pay off the other note when Subsidiary bought back the Equipment. Thus, Partnership in fact never had the burden of making the payments, since it was planned that both notes would be retired as part of Transaction Three and Transaction Four of the Bank Memo.

The only interest paid on the notes by Partnership seems to have been one-day's interest on the Finance Note for the day between the sale-leaseback transactions and the sale of a portion of the rental payments to Bank. Partnership had this amount wired by Bank to Taxpayer. Thus, Partnership never seems to have invested any of its own funds in the purported purchase of the Equipment.

Thus, this factor supports the view that there was no sale.

5. Was Partnership vested with the right of possession?

This factor has little importance in the transaction because the property was nominally leased back to Taxpayer and the lease was structured as a net lease. It should be noted that Partnership essentially had no right of possession and this right, pursuant to the sale and leaseback, resided with Taxpayer.

Additionally, Partnership had the right to repossess and sell or re-lease the Equipment if Taxpayer failed to make a rental payment. This factor may in fact be irrelevant since it was planned in the Bank Memo that Partnership would sell the property to Subsidiary in Transaction Four.

6. Who was obligated to pay property taxes?

This is a neutral factor, but one that has little importance in this transaction because the property was allegedly leased back to Taxpayer and the lease was structured as a net lease. It should be noted that Partnership had no requirement to pay property taxes because, pursuant to the "General Tax Indemnity" of the purported sale and leaseback, this obligation resided with Taxpayer. Because this was a net lease, this factor must be viewed as neutral.

7. Who bore the risk of economic loss or physical damage to the property?

This factor has little importance in this transaction because the property was allegedly leased back to Taxpayer and the lease was structured as a net lease. It should be noted that Partnership essentially had no risk of economic loss or physical damage to the property because, pursuant to the sale and leaseback, this risk resided with Taxpayer. Once again, the fact that this was structured as a net lease renders this factor neutral.[2]

8. Who received the profit from the property's operation, retention and sale?

This factor concerns whether Partnership received the profit from the operation, retention and sale of the Equipment. Courts have consistently found that the potential for profit or loss on the sale or re-lease of property is a key burden or benefit of owning property. *Gefen v. Commissioner*, 87 T.C. 1471, 1492 (1986); *Illinois Power Co. v. Commissioner*, 87 T.C. 1417, 1437 (1986).

Taxpayer operated the Equipment and benefitted from any profit arising from the operation. However, this is typical in a net lease situation.

The substance of the transactions seems to be that Taxpayer transferred the Equipment to its subsidiary and borrowed approximately $y from Bank. The transfer of the preferred stock to Partnership appears to have been a fee for its role in the transaction. There does not seem to be any reason other than tax planning for structuring the transactions as they were. In particular, there seems to be no economic reason for Taxpayer to structure the transaction in a way that caused Partnership to acquire the preferred stock unless Taxpayer was paying Partnership a fee for its role in the transaction.

Because the substance of the transaction was a financing, it should be treated as a financing.

Additional factors:

1. Did the property have a useful life in excess of the leaseback term?

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[2] We note in the context of net leases, these factors are neutral and do not, in themselves, support disallowance of ownership-associated tax benefit. They can be used to support an economic analysis that the taxpayer had neither a profit interest or a potentiality of loss in the transaction because the nominal lessee was obligated to pay all taxes and operating expenses and incurred the risk of economic loss on the property.

Since it was contemplated that Subsidiary would acquire the Equipment, this factor may not be significant. Still, if the useful life of the Equipment was less than the leaseback term, that would favor not treating the sale-leaseback as a bona fide transaction.

2. Was there a purchase option at less than fair market value?

The lease provided Taxpayer the option to buy the Equipment back for fair market value at the end the lease term. However, this may not be significant since it was planned that Subsidiary would acquire the Equipment in Transaction Four.

3. Were renewal rentals at the end of the leaseback term set at a fair market value rate?

There is no indication in the facts presented of whether the lease provided for renewal rentals. Nevertheless, as discussed above, this may not have been significant since it was expected that Subsidiary would acquire the Equipment in Transaction Four.

4. Was there a reasonable possibility that the purported owner of the property can recoup its investment in the property from the income producing potential and residual value of the property?

In this case, there never seems to have been a serious possibility that the purported buyer, Partnership, intended to recoup its investment from the income producing potential and residual value of the property. It was planned that Partnership would sell the Equipment to Subsidiary. The only profit to Partnership was in the preferred stock that Partnership acquired in the purported §351 transaction. As discussed above, this preferred stock was a fee for Partnership's role in the transaction. In fact, Partnership, made no up-front investment in the purchase of the Equipment. Partnership paid the entire purchase price by issuing two notes. Partnership did not expect to have to make payments on these notes. It planned to retire one of the notes by selling a portion of the rental payments to Bank. It planned to retire the other note in the §351 transaction.

This is a strong argument that no sale took place.

Based on the factors in *Grodt & McKay Realty* and the added factors relating to sale and leaseback transactions in *Torres*, the sale and leaseback transaction that Taxpayer entered into could be recharacterized as a financing transaction whereby Taxpayer transferred the equipment to its subsidiary and Partnership was never the bona fide owner. The primary reason for characterizing the transaction as a financing arrangement is that it represents the economic substance of the transactions, which is that Taxpayer transferred its Equipment to a subsidiary and borrowed approximately $y from Bank.

We believe that the benefits and burdens of ownership of the Equipment did not pass to Partnership. Accordingly, we support treating the transactions as a financing.

Issue 3: Section 351

1. The acquisition failed to satisfy the technical requirements of I.R.C. §351.

Section §351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock, and, immediately after the exchange, the transferor or transferors are in control of the corporation. "Control" is defined in §368(c), which provides that control requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Transitory phases of an arrangement frequently are disregarded where they add nothing to the completed affair. See *Gregory v. Helvering*, 293 U.S. 465 (1935); *Helvering v. Bashford*, 302 U.S. 454 (1938); see also Rev. Rul. 83-142, 1983-2 C.B. 68; Rev. Rul. 78-397, 1978-2 C.B. 150.

Before the putative §351 transaction, Taxpayer wholly owns Subsidiary. Taxpayer's transfer of $q to Subsidiary was coordinated with Partnership's transfer of property to Subsidiary and Subsidiary's assumption of Partnership's obligation to Taxpayer. The facts indicate that Taxpayer's transfer of $q to Subsidiary occurred in Date 4, and that Subsidiary's payment of $q back to Taxpayer occurred on Date 12. Taxpayer characterized Subsidiary's payment back to Taxpayer part as dividend and part as satisfaction of the debt assumed by Subsidiary as part of the putative §351 transfer from Partnership.

The transfer of cash from Taxpayer to Subsidiary and the transfer of the cash back to Taxpayer shortly thereafter may be disregarded as a transitory circular flow of cash. The cash transfers were coordinated with Partnership's transfer of property to Subsidiary and Subsidiary's assumption of Partnership's debt to Taxpayer. The circular flow of the $q between Taxpayer and Subsidiary appears to have constituted a mere transitory step to allow Partnership to receive §351 treatment on its transfer. Thus, the transfers of cash should be disregarded. See *Gregory v. Helvering*, 293 U.S. 465 (1935). Further, to the extent that Partnership's obligation to Taxpayer is respected as bona fide debt, it may be argued that Subsidiary's assumption of Partnership's obligation to Taxpayer, combined with the transfer of cash from Taxpayer to Subsidiary and then back should be stepped together to constitute forgiveness by Taxpayer of Partnership's obligation.

Because the cash transfers should be disregarded, the transfer of property from Partnership to Subsidiary must be analyzed separately under §351. Under this analysis, because Partnership would not have been in control of Subsidiary following such transfer, the transfer will fail to satisfy §351. We note that we do not know precisely how much time elapsed between the two cash transfers, and that the closer that they are in time, the stronger the circular flow of cash argument will be.

The acquisition of Subsidiary stock by Taxpayer and Partnership does not qualify under I.R.C. §351 and is therefore a taxable exchange subject to I.R.C. §1001.

2. <u>The transaction may lack a bona fide business purpose.</u>

Courts have held that a transaction meeting the statutory elements of §351 does not qualify for nonrecognition if it lacks a non-tax business purpose. *Caruth v. United States*, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987), aff'd on other issues, 865 F.2d 644 (5th Cir. 1989); *Stewart v. Commissioner*, 714 F.2d 977, 992 (9th Cir. 1983).

In *Caruth*, the taxpayer transferred stock in a closely held corporation to his wholly owned corporation four days before the closely held corporation declared a large dividend. The government argued that the dividend should be recognized by the taxpayer because his transfer of the closely held stock to his wholly owned corporation had no business purpose. The taxpayer argued that §351 did not require a business purpose. The Court's opinion traced the development of §351 and concluded that the provision is tied very closely to the corporate reorganization provisions. On that basis, the court reasoned that the principles applicable to reorganizations were equally valid for transfers of property to a controlled corporation under §351 (i.e., that §351 requires a valid business purpose).

In *Kluener v. Commissioner*, T.C. Memo. 1996-519, aff'd, 154 F.3d 630 (6th Cir. 1998) the taxpayer sold his thoroughbred horses to raise funds to meet loan obligations. He transferred the horses to his wholly owned corporation, which subsequently sold the horses at auction. The corporation reported the sale of the horses on its tax return but offset the gain with a loss carryover. Rather than use the proceeds from the sale of the horses for its own purposes, the corporation held the funds in a separate account for several months and then distributed the entire amount to the taxpayer, who used part of the funds to pay loans and lent part back to the corporation. The Tax Court held that, in substance, the taxpayer sold the horses using the corporation as a conduit. On appeal, the Sixth Circuit affirmed. In discussing §351, the Court summarized the application of the business purpose requirement by noting that a shareholder's transfer of property to his closely held corporation is not taxed "if the transfer occurred for a valid, non-tax business purpose" but that the Code will tax a shareholder who transfers property solely to avoid taxes.

In *Kluener*, the Sixth Circuit Court of Appeals identified the standards used to determine whether there is a business purpose for a transfer. These factors include:

> Whether the transfer fulfilled its stated purpose; the extent to which the transferor, rather than the transferee, benefitted from the transfer; the extent to which the transferee needed the property; the length of time between the transfer and subsequent events; the number of such transfers; the taxpayer's expertise in tax matters; and the transactions' form. Courts also examine any explicit indicators of a taxpayer's intent, such as documents or negotiations that confirm or belie the existence of a prearranged plan.
>
> 154 F.2d at 635.

You have indicated that the facts as currently developed do not suggest a plausible business purpose for the putative §351 transactions. If the Taxpayer does provide a purported business purpose for this transaction you should attempt to get as many details as possible and address any defects in that explanation. After this occurs, you may wish to seek our further advice on the matter.

Issue 4: Capitalization

For purposes this issue, we assume that the payments by Taxpayer to Bank will be treated as payments of rent for the Equipment. It should be noted that Taxpayer did not treat these payments as rent. It deducted them as depreciation and interest.

Section 162(a)(3) allows a deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rent. See also §1.162-1.

Section 263(a) provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

There is a “well-settled general rule that when an obligation is assumed in connection with the purchase of capital assets, payments satisfying the obligation are non-deductible capital expenditures.” *Webb v. Commissioner*, 708 F.2d 1254, 1256 (7th Cir. 1983) (pension payments).

The Supreme Court has held that payment of a tax lien by a subsequent purchaser is not the discharge of a burden which the law has placed upon him, but is actually as well as theoretically a payment of purchase price. *Magruder v. Supplee*, 316 U.S. 394, 398 (1942). In *Magruder* the taxpayer had purchased real estate and paid taxes on the property for the current year that had not been paid by the seller at the time of the purchase. The Court reasoned that the buyer has agreed to pay taxes which were the personal liability of the seller. The Court stated that taxes “are not like rent, nor are they paid for the privilege of occupying property for any given period of time.” *Magruder*, 316 U.S., at 398. The Court held the payment of the taxes, which was an obligation of the seller, was part of the purchase price.

In *Subsidiaryific Transport Co. v. Commissioner*, 483 F.2d 209, 214 (9th Cir. 1973), a court citing *Magruder* held that the payment by a parent to discharge a contingent tort liability of a subsidiary upon liquidating the subsidiary is part of the cost of acquiring the assets of the subsidiary.

Here, Taxpayer is not agreeing to pay an existing obligation at the time of acquiring the property. Rather the payments would be rent for the use of the property. The Court in *Magruder* stated that payments for the privilege of using property are not capitalized as an acquisition cost.

Therefore, the payments by Taxpayer to Bank are not capital expenditures.

Issue 5: Penalties

Section 6662(a) imposes a penalty in an amount equal to 20% of the underpayment of tax attributable to one or more of the items listed in §6662(b). These items include negligence, substantial understatements of income tax, and substantial valuation misstatements under chapter 1.

1. Negligence

“Negligence” includes a failure to make a reasonable attempt to comply with provisions of the internal revenue laws or failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See §6662(c); *Martello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), aff’g on this issue, 43 T.C. 168 (1964); §1.6662-3(b)(1). A return position that has a reasonable basis is not attributable to negligence, but negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item "which would seem to a reasonable and prudent person to be 'too good to be true' under circumstances[.]" Section 1.6662-3(b)(1). The accuracy-related penalty does not apply with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. See §6664(c)(1). The determination of whether the taxpayer acted with reasonable cause and in good faith depends upon the pertinent facts and circumstances. See §1.6664-4(b)(1). The most important factor is the extent of the taxpayer's effort to assess the proper tax liability for the year. See *Id.* The negligence penalty can be applied to deficiencies resulting from the application of the economic substance doctrine. *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214, 226-27 (1999).

We conclude that Taxpayer was negligent and that the accuracy-related penalty under §6662(a) should be applied to the deficiencies resulting from the disallowance of the portion of rent paid by Partnership which was deducted as a second depreciation deduction. Taxpayer has offered no evidence that there was reasonable cause for its return position or that it acted in good faith in asserting them. There is no evidence that Taxpayer thoroughly investigated the bona fide economic aspects of the lease stripping transaction or reasonably relied on professional advice that the deductions are allowable. See *Freytag v. Commissioner*, 904 F.2d 1011, 1017 (5th Cir. 1990); §1.6664-4(c).

2. Substantial Understatement of Income

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000. I.R.C. §6662(d)(1)(A). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. I.R.C. §6662(d)(2)(B). Tax shelter means, as is relevant here, any plan or arrangement a significant purpose of which is the avoidance or evasion of Federal income tax. I.R.C. §6662(d)(2)(C)(iii).

The facts support the position that the series of transactions in which Taxpayer and its Subsidiary claimed "depreciation" deductions twice on the same property was a tax shelter. Any understatement that results from the disallowance of the principal which is deducted will, be substantial, and should be subject to the penalty provided by §6222(a) unless Taxpayer reasonably believed that the tax treatment of the item was more likely than not the proper treatment. As discussed above in connection with negligence, the facts as currently developed do not satisfy even the lower reasonable standard that applies for purposes of determining negligence. See §1.6662-4(d)(2).

Even if the series of transactions in which Taxpayer created two sets of deductions was not a tax shelter, the deficiencies that result from the disallowance, if substantial, should be subject to the penalty provided for under §6662(a). If the transactions were not a tax shelter, the understatement will be reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for such treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. Section 6662(d)(2)(B). Neither of these exceptions apply. The substantial authority standard is higher than the reasonable basis standard. Section 1.6662-4(d)(2). As was discussed regarding negligence, the facts as currently developed do not support a conclusion that Taxpayer had even a reasonable basis for claiming the rental deductions. In addition, there is no indication that the relevant facts affecting the item's tax treatment were disclosed in Taxpayer's return or in attached statements.

Note that, in determining the total amount of penalties imposed, where at least two penalty rates may apply or where there is an adjustment with respect to which no penalty has been imposed the ordering rules of §1.6664-3 should be followed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In order to ascertain whether legal title had passed it would be useful to look into whether there was any reasonable possibility that Partnership would have wanted to retain ownership of the Equipment, instead of transferring ownership to Subsidiary. This could depend on factors such as whether Partnership was normally in the business of using or leasing the kinds of equipment involved in the sale-leaseback. It could also depend on whether Partnership would have had any reason to keep the Equipment at the end of the lease term or whether Partnership could have leased it to a party other than Taxpayer.

In analyzing whether the parties treated the transaction as a sale, it would be worth looking into whether communications among the parties prior to the transactions treat the transactions as a financing. Also, an explanation of how Taxpayer computed the depreciation deductions might indicate whether Taxpayer relinquished its ownership of the assets.

It would be useful to look into whether Subsidiary existed as an operating corporation or was merely an accounting entry on Taxpayer's books. If Subsidiary were merely an empty shell, that would strengthen the idea that the transactions were carried out merely for tax planning purposes.

It would be worth looking into whether Taxpayer really sold the Equipment for fair market value to Partnership. The appraised value of the Equipment was the same as its basis. If the fair market value was not the same as the purchase price, that would make it more likely that there was no bona fide sale and the parties were trying to avoid having any gain or loss recognized on the purported Equipment sale.

In determining whether Partnership was vested with the right of possession, it may be worth examining whether there was any realistic possibility that Partnership would have been able to sell or rent the Equipment to another business in the event of default.

Who would benefit from retention and sale of the property after the expiration of the lease term is a key issue in sale-leaseback cases. It would be worth looking into whether there was any realistic possibility that Partnership would not have transferred the Equipment to Subsidiary in Transaction Four. Since it was contemplated that the property would be transferred to Subsidiary, it is less significant whether Partnership was likely to continue to be the owner of the Equipment after the lease term, but it may be worth looking into whether there was any possibility that Partnership would have remained the owner of the property until the end of the lease term and then continued to own the Equipment after that.

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Please call if you have any further questions.

ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS AND SPECIAL INDUSTRIES

By: ______________________________
MATTHEW LAY
Senior Technician Reviewer
CC:PSI:2